PRICEWATERHOUSECOOPERS

PREMERA

Addendum To Exhibit 1

Report on Tax Matters in Connection with The Washington Foundation Shareholder and The Alaska Health Foundation – Proposed Unallocated Shares Escrow Agreement

Prepared for the Washington Office of the Insurance Commissioner

Premera Conversion Transaction

Proposed Unallocated Shares Escrow Agent Agreement

In the event that Alaska and Washington do not agree on or before the closing of the proposed Conversion Transaction on allocation of all or any portion of the stock of New Premera to be distributed between the Washington Foundation Shareholder (the "WA Foundation") and the Alaska Health Foundation (the "AK Foundation") (collectively, the "Foundations"), or having agreed, New Premera is precluded from delivering such stock to the Foundations, PREMERA proposes that New Premera deposit the so-called Unallocated Common Shares with an Unallocated Shares Escrow Agent (the "Escrow Agent") to be held and administered under an Unallocated Shares Escrow Agent Agreement (the "Escrow Agreement"). Contemporaneously with the execution of the Escrow Agreement, the Foundations would acquire beneficial ownership representing 100% of the issued and outstanding shares of New Premera.

By the terms of the Escrow Agreement, the Escrow Agent is directed to release the Unallocated Common Shares and any proceeds from the sale thereof, and investment income thereon as invested and reinvested, to the Foundations upon receipt of instructions jointly signed by the Foundations' respective duly authorized representatives, and delivered to New Premera and the Escrow Agent. Upon receipt of jointly written instructions from the Foundations regarding allocation of the Unallocated Common Shares, the Escrow Agent is further instructed to deliver the certificate(s) representing the Unallocated Common Shares to New Premera for reissue in appropriate amounts pursuant to such agreed allocation. So long as held under the terms of the Escrow Agreement, the Escrow Agent is deemed to be the record holder of all Unallocated Common Shares.

The Escrow Agent is directed by the Escrow Agreement to hold all dividends on the Unallocated Common Shares for the benefit of the Foundations. In the event of liquidation of New Premera, the Escrow Agent is directed to distribute any assets received attributable to the Unallocated Common Shares (net of costs and expenses) to the Foundations in accordance with mutually agreed upon written instructions. In the absence of agreement between the Foundations, the Escrow Agent may seek resolution of ownership as between the Foundations by instituting a bill of interpleader in a court of competent jurisdiction. To the extent that New Premera stock is sold by the Escrow Agent, the resulting funds and any earnings thereon (net of costs and expenses) are to be distributed to the Foundations as they shall agree and otherwise as may be determined by a court of competent jurisdiction.

Section II of the Escrow Agreement implies that neither New Premera, nor the Escrow Agent, shall have any tax obligations with respect to investment income derived from reinvestment of proceeds from the sale of Unallocated Common Shares. (There is an apparent typographical error in the key sentence of this provision which should be corrected to prevent any doubt in this regard. It is also recommended that consideration be give to expressly providing that neither New Premera, nor the Escrow Agent, have any tax obligations whatsoever with respect to the Escrow Property.)

The Escrow Agreement requires the Foundations to pay the Escrow Agent's reasonable fees and expenses as incurred. The Escrow Agent generally is entitled to indemnification by the Foundations. The Escrow Agent's only expressed duties under the Escrow Agreement are to safeguard the Unallocated Common Shares and any monies held in the Escrow Account, to vote such shares as explicitly set forth in the Escrow Agreement and to dispose of and deliver the same in accordance with the terms of the Escrow Agreement. In general, the Escrow Agent must vote the Unallocated Common Shares with reference to decisions made by the Independent Board Majority, and in certain instances, as directed by the Foundations.

Federal Income Tax Considerations Resulting From the Proposed Escrow Agreement

For purposes of Federal tax information reporting it is not clear how the activities of the Escrow Agent with respect to the Unallocated Common Shares should be annually reported by either the Foundations or the Escrow Agent. While it would appear that the Escrow Agent should not be treated, for Federal income tax purposes, as taxable on any income derived from or in connection with the Unallocated Common Shares, it may be necessary to seek and obtain formal confirmation of this conclusion from the IRS as well as formal guidance regarding the appropriate way the parties should report the activities of the Escrow Agent with respect to the Unallocated Common Shares and funds derived therefrom.

In general, the tax rules governing escrow arrangements, for the most part, are unsettled.[1] Section 468B(g) of the Internal Revenue Code of 1986, as amended (the "Code"), provides that escrow accounts are subject to current income taxation; however, the manner of taxation is unclear. Many commentators agree that the best approach for parties entering into an escrow agreement – particularly when the escrow account does not constitute a formal trust or a "designated settlement fund" or other arrangement expressly subject to special treatment under Section 468B – is for the parties to agree who will be treated for Federal income tax purposes as the owner of the escrow property and the income derived from that property.[2] The form and structure of the transactions chosen by the parties can be very important where escrows are concerned. Although there are special tax rules applicable to certain escrows under Section 468B, those rules do not appear to apply to the Escrow Account or any of the parties to, or transactions contemplated by, the Escrow Agreement. Section 468B and its corresponding final and proposed Treasury Regulations provide special rules for escrow funds qualifying as "designated settlement funds," "qualified settlement funds," "pre-closing escrows," "contingent at-closing escrows" and "disputed ownership funds." These specially treated escrow funds are discussed below.

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[1] *See generally* Wilcox, Gary B., "Settlement Fund Final Regs. Answer Many Questions, But Problems Still Exist," 78 J. Tax'n 342 (June, 1993); Harrison, Ellen K., "IRS Fills Void on Tax Treatment of Settlement Funds with Generally Favorable Rules," 76 J. Tax'n 358 (June 1992); Kubasiak, Gerald E., "Tax Break Available to Class Action Defendants, But Ambiguities Remain," 70 J. Tax'n 276 (May, 1989); Faas, Peter M., "Tax Aspects of Real Estate Investments," 1A Tax Asp. Real Est. §11:81; 2 Mertens Law of Fed. Income Tax'n §12A:36.

[2] *See e.g.*, Wellen, Robert H., "Contingent Consideration and Contingent Liabilities in Acquisitions," 580 PLI/Tax 883, 962 (October-November, 2003); 770-2d T.M., *Structuring Corporate Acquisitions – Tax Aspects*, at §IV(D)(1).

A "designated settlement fund" is any trust or other fund that: (1) is established pursuant to a court order; (2) is established in order to extinguish completely tort liabilities with respect to personal injury, death, or property damage claims; (3) cannot receive transfers other than qualified payments; (4) is to be administered by persons at least a majority of whom are independent of the transferors; and (5) grants no beneficial interest in either income or principal to the taxpayer or any related person; and (6) is the subject of an election made under Section 468B of the Code. The gross income of a designated settlement fund, less certain expenses, is taxed currently at the maximum rate applicable to trusts under Section 1(e) of the Code. In computing its tax liability, a designated settlement fund may deduct administrative costs, including state and local taxes, and other incidental expenses, such as legal and accounting costs, that are incurred in connection with the operation of the fund, if the costs would have been deductible had the designated settlement fund been a corporation.

Section 468B directs the Internal Revenue Service to promulgate regulations prescribing how other settlement funds should be taxed. The Internal Revenue Service published these regulations in 1992, extending the same treatment otherwise available to designated settlement funds to a broader range of funds, known as "qualified settlement funds." The regulations state that a fund is a "qualified settlement fund" if: (1) it is established pursuant to an order of, or approved by, the United States, any state or political subdivision, or any agency or instrumentality, including a court, of any of them; (2) it is established in order to satisfy or resolve at least one claim that resulted from an event or series of events that have occurred and that give rise to liabilities under Federal environmental legislation, a tort, breach of contract, or violation of law, or an event that is designated by the IRS in a revenue ruling or revenue procedure; and (3) it is either a trust under applicable state law or its assets must be otherwise segregated from other assets of the transferor (and related persons). It does not appear that the Escrow Agreement is a "qualified settlement fund" because it is not established "in order to satisfy or resolve at least one claim that resulted from an event or series of events that have occurred and that give rise to liabilities under Federal environmental legislation, a tort, breach of contract, or violation of law, or an event that is designated by the IRS in a revenue ruling or revenue procedure."

Proposed Treasury regulations under Section 468B of the Code apply special tax rules for "pre-closing escrows," "contingent at-closing escrows" and "disputed ownership funds." These proposed regulations, however, generally would apply only to escrow accounts established after the date final regulations are published in the Federal Register. *See* Prop. Treas. Reg. §§1.468B-7(e)(1), 1.468B-8(h)(1), and 1.468B-9(h)(1). With respect to a "pre-closing escrow," "contingent at-closing escrow" or "disputed ownership fund" established on or before the date of publication of final regulations in the Federal Register, the proposed regulations provide that Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for income earned by the escrow. And, the Internal Revenue Service will also not challenge a reasonable, consistently applied method for reporting such income. *See* Prop. Treas. Reg. §§1.468B-7(e)(2), 1.468B-8(h)(2), and 1.468B-9(h)(2).

Although not completely free from doubt, if for Federal income tax purposes the parties entering into the Escrow Agreement agree to a reasonable, consistently applied method of reporting and taking into account transfers to the Escrow Account, income realized by the Escrow Account, and distributions made by the Escrow Account, the Internal Revenue Service should respect such treatment (and not automatically subject the Escrow Account to taxation on the income realized with respect to the Escrow Account assets).[3]

Possible Forms of Tax Understanding Among Escrow Agent, New Premera and the Foundations

There are at least two alternative forms of a tax understanding among the parties that merit consideration with respect to reporting and taking into account for Federal tax purposes economic activity with respect to the Unallocated Shares as follows:

ALTERNATIVE 1: Interim Agreement To Allocate Beneficial Ownership For Tax Purposes

In general, for Federal tax purposes, the terms of the Escrow Agreement are consistent with treating the Foundations (and not New Premera or the Escrow Agent) as the beneficial owners of the Escrow Property and income earned thereon. For example, the Foundations are expressly treated as the beneficial owners of 100% of the issued and outstanding shares of New Premera. The Foundations economically bear the costs associated with administering the Escrow Account. The Escrow Property, and all income accruing in the Escrow Account is held for the benefit of, and is ultimately distributable to, the Foundations.

These terms are consistent with the apparent intent of the parties that the Foundations report and take into account for Federal income tax purposes transfers to the Escrow Account, income realized in connection with the Escrow Property and distributions made from the Escrow Account. (Consistent with this intent, the Foundations should provide the Escrow Agent with properly completed IRS Forms W-9 (Certificates of US Status) that the Escrow Agent may require to report any amounts distributed or distributable to the Foundations on an IRS Form 1099 (Series)).

From a practical perspective, however, the Escrow Agent and each Foundation must adopt a method for Federal tax purposes of reporting and taking into account on an annual basis: (a) transfers to the Escrow Account; (b) income realized by the Escrow Account; and (c) distributions made by the Escrow Account – particularly if the term of the Escrow Account is more than twelve months.

[3] Treasury Regulation Section 1.468B-5(b)(1)(i) provides that this method would be respected for escrow arrangements established prior to February 15, 1992. Absent further guidance, however, for an escrow arrangement that does not constitute a "designated settlement fund" or other special arrangement under Section 468B, it seems reasonable to apply this method.

Due to the fact that the existence of any Unallocated Shares results in additional complexities, costs and some uncertainty it is obvious that Washington and Alaska should make every effort to agree to an allocation on behalf of the Foundations before the closing of the proposed Conversion Transaction. However, if that is not possible to achieve before it is otherwise determined to be in the best interests of the parties to consummate the proposed Conversion Transaction it nevertheless may be possible for Washington and Alaska to agree upon an interim allocation ("Escrow Term Percentage"), for tax purposes only and without prejudice to either party's position in connection with the process by which the final allocation is determined.

An agreement to utilize an Escrow Term Percentage could be easily incorporated into the proposed Unallocated Shares Escrow Agreement to facilitate a numerical annual allocation of interests in the Escrow Property for financial accounting as well as tax purposes. An essential and integral part of such agreement would involve a final reconciliation, on a cumulative basis, between the parties' interests in the Escrow Property utilizing the Escrow Term Percentage and the actual allocation percentage as ultimately agreed (or otherwise determined), which would be the basis for distributions from the Escrow Account (the "Final Distribution Percentage").

Throughout the term of the Escrow Account, each Foundation would report on its Form 990, *Return of Organizations Exempt From Income Tax*, its respective Escrow Term Percentage of the Escrow Account's assets, liabilities, income, credits and expenses. (The Foundations may wish to disclose, through footnotes or otherwise, on their respective Forms 990 that the amounts reported attributable to the Escrow Account may be subject to adjustment depending on the resolution of Final Distribution Percentages, with such adjustment to be reflected on their respective Forms 990 when such Final Distribution Percentages are determined.)

When the Final Distribution Percentages are determined, each Foundation would report on its Form 990 its respective Final Distribution Percentage of the Escrow Account's assets, liabilities, income, credits and expenses, and make appropriate adjustments attributable to the discrepancy, if any, between its respective Escrow Term Percentage and Final Distribution Percentage accounts. If there is such a discrepancy, the Foundations may wish to disclose it through footnotes or otherwise on their respective Forms 990 for the year in which the Final Distribution Percentages are determined.

This method may require an additional agreement (a "True-Up Understanding") between the Foundations to make each other economically whole after their respective Final Distribution Percentages are determined in the event that they previously have paid fees or other expenses to (or received any amounts from) the Escrow Agent in disproportion to each Foundation's Final Distribution Percentages.

If this method is adopted, it is recommended that, to the extent possible, all parties consistently follow the same principles for financial accounting as well as tax purposes.

Assuming that it becomes necessary to adopt an Unallocated Shares arrangement, the advantages of this structure likely outweigh its disadvantages. If the arrangement is respected for Federal income tax purposes, no Federal income taxes should be payable by any party attributable to income or gain realized with respect to the Escrow Property or on account of any of the transactions contemplated by the proposed Escrow Agreement. The Foundations, however, would need to agree on their respective Escrow Term Percentages and enter into a True-Up Understanding. Each Foundation would also have minor Form 990 disclosure and reporting issues each year the Escrow Account remains outstanding.

ALTERNATIVE 2: For Tax Purposes Only, Identify New Premera As The Interim Beneficial Owner of The Unallocated Shares

As a general rule, a corporation is not subject to Federal income tax on gain derived from its sale or other disposition of its stock.[4] Similarly, as a general rule, a corporation should not be subject to Federal income tax attributable to dividends paid with respect to its stock.[5] Accordingly, the Proposed Escrow Agreement could be modified to identify New Premera as the sole beneficial owner of the Unallocated Shares for Federal income tax purposes until the allocation of those Shares (and any funds, gain or other income derived therefrom) between Washington and Alaska is determined.

Pursuant to such an understanding, the Escrow Agreement would need to be modified in a number of respects to be consistent with the understanding among the parties that solely for Federal income tax purposes New Premera is deemed to be the beneficial owner of the Unallocated Shares and any funds, gain or other income derived therefrom, until the allocation of the Unallocated Shares is determined. New Premera would report on its Federal income tax return the Escrow Account's assets, liabilities, income, credits and expenses. When the allocation of the Unallocated Shares is determined the Escrow Agent would be directed by the terms of the Escrow Agreement to distribute the then Escrow Property to the Washington and Alaska Foundations consistent with such determination. For Federal tax purposes, each Foundation would report receipt of the share of the Escrow Property distributed to it in the same manner as it would report the initial receipt of the fully allocated New Premera Shares. (The Foundations may choose to report, by footnote or otherwise, a contingent interest in the Escrow Property.)

There are several disadvantages to such an arrangement. First, as the designated beneficial owner of the Escrow Property for Federal tax purposes, New Premera would likely be subject to income tax on any income derived from the Escrow Property other than gain from the sale of New Premera Shares or dividends declared and paid with respect to New Premera stock. (The Escrow Agreement would need to be modified to treat any resulting tax liabilities as a reimbursable expense incurred by New Premera on behalf of the Foundations.) Second, such an arrangement is complex and may be perceived as involving New Premera in the Escrow arrangement to an unreasonable and

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[4] IRC Section 1032.

[5] See, for example, Tech. Adv. Mem. 8022010 (1980).

inappropriate extent. Third, even though the tax reporting and liability consequences of such an arrangement may be as, or more, certain than an arrangement whereby Washington and Alaska agree for Federal tax purposes (and without prejudice to their respective positions) to Escrow Term Percentages, the tax reporting and consequences of such an arrangement are not without any doubt.